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BRIEF FOR RESPONDENT

In the Supreme Court of the United States

OCTOBER TERM 1932

No. 792

DAVID BURNET,
COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

FREDERICK B. WELLS

On a Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit

---

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BRIEF FOR RESPONDENT

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 45-50) is reported in 19 B. T. A. 1213. The opinion of the Circuit Court of Appeals (R. 56-83) is reported in 63 Fed. (2d) 425.

JURISDICTION

This Court is vested with jurisdiction under section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether section 219(h) of the Revenue Acts of 1924 and 1926 is unconstitutional as applied to a case where the grantor created an irrevocable trust for the payment of premiums on policies of insurance upon his life, and parted with all rights and benefits under such trust and under the insurance policies, prior to the enactment of said section of the Revenue Acts.

STATUTE INVOLVED

Part of section 219(h) of the Revenue Acts of 1924 and 1926:

> "* * * Where any part of the income of a trust is or may be applied to the payment of premiums upon policies of insurance on the life of the grantor * * * such part of the income of the trust shall be included in computing the net income of the grantor."[1]

STATEMENT

On December 30, 1922, Frederick B. Wells created three trusts, referred to as Trusts Nos. 1, 2 and 3. On August 6, 1923, he created two additional trusts, referred to as Trusts Nos. 4 and 5. All were in terms irrevocable. (R. 86-88, 95-99, 107-109, 120-123, 181-183.)

This was before the enactment of section 219(h) of the Revenue Act of 1924, or of any similar statute.

Under the terms of the trust indentures certain of

[1] Section 219(h) and other pertinent parts of section 219 are shown in full in the Appendix, pp. 36-37.

the income was to be paid by the trustee as premiums on policies of insurance on the life of the settlor. Prior to January 1, 1924, the settlor parted with all right, title and interest in the insurance policies.[1] In his income tax returns for 1924, 1925 and 1926, Mr. Wells did not report as his income any part of the income of the trusts used to pay premiums on the insurance policies. The Commissioner of Internal Revenue in auditing those returns added to Mr. Wells' income the amounts which had been paid by the trustee as premiums on the insurance policies. (R. 13-15, 23-25, 34-35.)

On review by the Board of Tax Appeals the action of the Commissioner was affirmed.[2]

Mr. Wells petitioned for review by the Circuit Court of Appeals for the Eighth Circuit. After argument the Circuit Court of Appeals on February 23, 1932, certified to this Court certain questions, as follows:

> Question 1. Does section 219(h) of the Revenue Acts of 1924 and 1926 apply to irrevocable trusts?
>
> Question 2. Is section 219(h) of the Revenue Acts of 1924 and 1926 constitutional as applied to irrevocable trusts created prior to the passage of the Revenue Act of 1924?
>
> Question 3. On the facts stated did the petitioner receive income arising under the trusts during the years 1924, 1925 and 1926?

---

[1] Except the right to disability benefits under certain accident insurance policies premiums on which were payable under Trusts Nos. 4 and 5.

[2] The deficiency for 1924 was increased by the Board on account of a clerical error discovered in the Commissioner's determination.

In their brief and on argument before this Court (April 27, 1932), counsel for the Government raised certain points as to the validity of the trusts and the ownership of the insurance policies, which had not been raised before the Board of Tax Appeals or before the Circuit Court of Appeals. This Court dismissed the certificate of the Circuit Court of Appeals on May 2, 1932. *Wells* v. *Commissioner,* 286 U. S. 529. Thereafter on motion of the Government, the Circuit Court of Appeals set the case for reargument and called for the exhibits which had been filed in the Board of Tax Appeals, in order to permit the Government to raise its new points.

On February 4, 1933, the Circuit Court of Appeals rendered an exhaustive opinion (R. 56-83; 63 Fed. (2d) 425-443) holding section 219(h) of the Revenue Acts of 1924 and 1926 unconstitutional when applied to the trusts under consideration (except that the Court held the income paid by the trustee as premiums on the accident policies, in which the settlor retained the right to disability benefits, properly taxable to the settlor.[1]) Accordingly, the Circuit Court of Appeals reversed the Board of Tax Appeals except as to the amounts of the accident insurance premiums.

This Court granted a writ of certiorari on petition of the Government on March 27, 1933.

The details of the provisions of the trust indentures and insurance policies and assignments thereof are set forth where pertinent in the argument below.

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[1] Respondent concedes the correctness of the decision of the Circuit Court of Appeals in this respect.

SUMMARY OF ARGUMENT

Mr. Wells throughout the taxable years involved had no interest in the corpus or income of the trusts nor in the life insurance policies. Section 219(h) of the Revenue Acts of 1924 and 1926 is unconstitutional in attempting to tax Mr. Wells upon the income of the trusts, for Congress is limited by the Fifth Amendment to the Constitution in the same manner that state legislatures are limited by the Fourteenth Amendment. *Heiner* v. *Donnan,* 285 U. S. 312. And a state cannot tax one person on the income of another. *Hoeper* v. *Tax Commission of Wisconsin,* 284 U. S. 206. The situation is entirely different from that in *Reinecke* v. *Smith* (April 10, 1933) and *Porter* v. *Commissioner* (March 13, 1933) where the settlor retained power to revoke the trust or to completely revise it and make different disposition of the property, but is similar to *Reinecke* v. *Northern Trust Co., 278* U. S. 339, where the title having been put beyond the control of the settlor the property was no longer a part of his estate.

The capriciousness of the tax imposed by section 219(h) of the Revenue Acts of 1924 and 1926 is demonstrated in the Revenue Act of 1932 under which a gift tax is imposed upon the creator of such a trust as those involved in the case at bar and the same statute continues to tax him on the income of the property of which he made a complete gift.

Every decision relied on by the Government is readily distinguishable from the present case, for in every one of them the settlor could, had he so desired, have paid the tax out of the taxed income, while in our case the settlor had put it out of his power to do this before

the first enactment of section 219(h) or anything like it, and before the beginning of the taxable periods covered by the statutes.

This Court has upheld income taxes when levied against the earners of the income or the owners of the property which earned the income, against persons who had reserved the right to revest in themselves title to corpus or income or to control the income, but the present case is parallel to none of those situations.

The trusts here involved were in no sense testamentary. *Nichols* v. *Coolidge,* 274 U. S. 531, 540. And the trust property could not have been taxed as a part of Wells' estate. *Coolidge* v. *Long,* 282 U. S. 582; *Lewellyn* v. *Frick,* 268 U. S. 238. Accordingly, the income therefrom could not properly be taxed to Mr. Wells. *Reinecke* v. *Smith* (April 10, 1933). The fact that the purposes served by the trusts were the settlor's purposes does not render him taxable on the income of the trusts any more than Mr. Rockefeller is taxable on the income of the Rockefeller Foundation.

If one renders services or leases property in consideration of payments to be made to a third party, such payments constitute income properly taxable to the one rendering the services or owning the property, whether such person was under obligation to the third party or not. But a gift from B to A is not taxable as income to A, whether paid directly to A or in discharge of A's obligation to C. Accordingly, the taxes in *Old Colony Trust Co.* v. *Commissioner,* 279 U. S. 716; *Adams* v. *Commissioner,* 18 B. T. A. 381; and *Danforth* v. *Commissioner,* 18 B. T. A. 1221, were properly upheld because the taxpayer in each case had earned the income though it had been paid on his account to another,

rather than because an obligation of his was discharged. Similarly, in *United States* v. *Boston & Maine Railroad,* 279 U. S. 732, and *United States* v. *Mahoning Coal Railroad Co.,* 51 Fed. (2d) 208, the income was earned by the property of the lessor railroads and was therefore taxable to them although paid to a third party. In the present case the income was earned by the corpus, which is the property of the trustee and is accumulated for the benefit of persons other than the settlor. The income is not earned by property or efforts of the person to whom it is proposed to tax it.

The fact that the settlor has discharged a moral obligation by creating these trusts does not render him taxable on the income therefrom any more than if he had discharged his moral obligation by a direct gift to the beneficiaries.

There is no evasion in electing a method of managing one's affairs which will result in no tax liability. Congress is not at liberty to violate the Constitution in its effort to prevent such avoidance.

Since these trusts were created irrevocably before the effective date of the first statute, the subject thereof was no part of the estate of Mr. Wells. *Nichols* v. *Coolidge,* 274 U. S. 531, 542-3. And "the same considerations as to ownership and control affect the power to impose a tax on the transfer of the corpus and upon the income." *Reinecke* v. *Smith.*

The Government's contentions with respect to particular trusts, attempting to show that the settlor retained interests thereunder, are fully answered in the opinion of the Circuit Court of Appeals.

The decree of the Circuit Court of Appeals should be affirmed.

ARGUMENT

POINT I

Mr. Wells Throughout the Taxable Years Involved Had No Interest in the Corpus or Income of the Trusts Nor in the Life Insurance Policies.[1]

The deeds of trust are in the record. (R. 86-95, 107-120, 181.) They are summarized in the findings of the Board of Tax Appeals. (R. 37-41.) The Board of Tax Appeals in its opinion recognized (R. 48) "that petitioner by the trust indentures and by the assignments of insurance policies has parted with all rights to revest such property in himself." The Commissioner of Internal Revenue had made a similar finding (R. 14-15), saying: "The fact that the trust in the instant case was irrevocable and that the grantor was not and could not be a beneficiary under these life insurance policies does not justify the conclusion that the income of these trusts is not taxable to the grantor."

The Commissioner and the Board justified the tax against the settlor on the theory that, in spite of his lack of any legal interest in the corpus of the trusts or the life insurance policies, it was proper to tax him on the trust income by reason of some "moral" or "economic" benefit.

The arguments of the Government to the effect that the trusts were revocable and that the settlor retained property in the insurance policies are answered under Point IV, below.

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[1] The taxability to the settlor of the premiums on the *accident* insurance policies, in which he retained an interest, is conceded. *cf.* pp. 3, 4, *supra.*

POINT II

As Applied to the Income of the Trusts Here Involved Section 219(h) of the Revenue Acts of 1924 and 1926 Is Unconstitutional.

(a) *As an income tax.*

The statute as applied by the Government imposes a tax upon Mr. Wells measured by income in which he has no property rights and over which he can exercise no control. This income is derived from a corpus in which Mr. Wells has no ownership, no power of disposition or appointment, no right to revest, no rights of any kind. The income is devoted to paying premiums on insurance policies which Mr. Wells does not own—in which he has parted with the rights to surrender, to pledge, to change beneficiaries and every other right he may have had.

Congress is limited by the Fifth Amendment to the Constitution in the same manner that the state legislatures are limited by the Fourteenth Amendment. *Heiner* v. *Donnan,* 285 U. S. 312. Accordingly Congress has no more power to tax Mr. Wells upon the income from property he has irrevocably given away than it has to tax him on the income from property he has sold or the income from property he never owned. As Mr. Justice Roberts wrote in *Hoeper* v. *Tax Commission of Wisconsin,* 284 U. S. 206, 215:

> "We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one per-

son's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the Fourteenth Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income." Compare Nichols v. Coolidge, 274 U. S. 531, 540.

Although *Knowlton* v. *Moore,* 178 U. S. 41, seems to have been modified by *Stebbins* v. *Riley,* 268 U. S. 137, we do not believe this Court will repudiate the following language from the earlier case:

> "But this is equivalent to saying that the principle underlying the asserted interpretation is that the house of A, which is worth only $1,000, may be taxed, but that the rate of tax is to be determined by attributing to A's house the value of B's house, which may be worth a hundredfold the amount. The gross inequalities which must inevitably result from the admission of this theory are readily illustrated."

With the same thought in mind, in *Hartman* v. *Greenhow,* 102 U. S. 672, which involved the validity of a statute requiring a tax on bonds to be deducted from coupons, which were detached and held by different owners, this Court said:

> "Surely it is not necessaary to argue that an act which requires the holder of one contract to pay the taxes levied upon another contract held by a stranger cannot be sustained. Such an act is not a legitimate exercise of the taxing power; it under-

takes to impose upon one the burden which should fall, if at all, upon another."

cf. *Rosenwald* v. *Commissioner,* 33 Fed. (2d) 423, cert. denied 280 U. S. 599.

(b) *As a gift tax.*

The Government concedes (Brief p. 21) that this tax cannot be sustained as a gift tax.

POINT III

The Capriciousness of the Tax Imposed by Section 219(h) of the Revenue Acts of 1924 and 1926 Is Demonstrated in the Revenue Act of 1932.

The Revenue Act of 1932 continues the tax imposed by section 219(h) of the Acts of 1924 and 1926 in the following language:

> "Sec. 167. Income for Benefit of Grantor.
> "(a) Where any part of the income of a trust—
> "(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or
> "(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or
> "(3) is * * * applied to the payment of premiums

upon policies of insurance on the life of the grantor * * *;

"then such part of the income of the trust shall be included in computing the net income of the grantor."

Section 501 of the Revenue Act of 1932 imposes a gift tax in the following language:

"(a) For the calendar year 1932 and each calendar year thereafter a tax, computed as provided in section 502, shall be imposed upon the transfer during such calendar year by any individual, resident or non-resident, of property by gift.

"(b) The tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; * * *

"(c) The tax shall not apply to a transfer of property in trust where the power to revest in the donor title to such property is vested in the donor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such property or the income therefrom, but the relinquishment or termination of such power (other than by the donor's death) shall be considered to be a transfer by the donor by gift of the property subject to such power, and any payment of the income therefrom to a beneficiary other than the donor shall be considered to be a transfer by the donor of such income by gift."

Congress, by taxing as gifts the creation of irrevocable trusts (without any exception for trusts to pay insurance premiums), recognizes the completeness of the transfer. By excepting revocable trusts from the

gift tax, it recognizes that incomplete transfers should not be taxed as gifts. In the case of a revocable trust it is consistent in taxing the income to the creator of the trust until such time as he makes the gift complete and ceases to be the owner (actual or potential) of the source of the income.

But in the case of a trust to pay insurance premiums, Congress taxes the grantor on a transfer by gift and then continues to tax him on the income of that gift as if no transfer had been made. It is submitted that this is certainly arbitrary and capricious and a denial of due process of law.

When an irrevocable trust is set up to pay insurance premiums on policies in which no interest is retained by the grantor, it is proper to tax the grantor upon the creation of such trust if Congress desires to impose a gift tax. But it is improper to tax the income of that trust to the grantor, for it is not his income. As was said by Mr. Justice Sutherland in *Heiner v. Donnan, supra*:

> "Such an exaction is not taxation but spoliation."

POINT IV

The Government's Argument Answered

(1) *The Constitutional question*

It may be true, as urged by the Government (Brief, pp. 9-10), that "The Fifth Amendment does not require Congress to levy the tax upon the beneficial owner of income." But this Court has never held that a person

could be taxed upon income unless he was the earner of the income, the owner of the principal from which the income was derived, or entitled in some manner to possess, control or dispose of either the principal or the income. Every decision relied on by the Government is readily distinguishable from the present case.

In *Lucas* v. *Earl,* 281 U. S. 111, the tax upon Mr. Earl was justified on the ground that he was the earner of the income. In *Burnet* v. *Leininger,* 285 U. S. 136, the tax was justified on the ground that the taxpayer was the owner of the corpus from which the income was derived.

In *Poe* v. *Seaborn,* 282 U. S. 101, this Court held that income which belonged to a wife under the community property laws of the state was not taxable to the husband under the Revenue Act of 1926. In saying (p. 109) that a statute should be construed to tax income to its owner "in the absence of further definition by Congress," this Court did *not* intimate, as the Government would imply, that if Congress so desired it could define as income of A something which was actually the income of B.

The present case is entirely different from *Corliss* v. *Bowers,* 281 U. S. 376, for in the latter the taxpayer, by exercising his power of revocation, could have made the income his own. By refraining from exercising it he was in effect making a series of gifts of the various items of income as they accrued. He could have decided to keep any one of them *and thus could have subjected the taxed income to the payment of the tax.*

In *Reinecke* v. *Smith* (April 10, 1933) the *ratio decidendi* was that for practical purposes the settlor of

the trust had retained a power of revocation, since the exercise of that power by him required only the association of a trustee who had no adverse interests. As Mr. Justice Roberts wrote:

> "A settlor who at every moment retains the power to repossess the corpus and enjoy the income has such a measure of control as justifies the imposition of the tax upon him."

The settlor in the case at bar retained no power to repossess either the corpus or the income for any purpose.

In *Porter* v. *Commissioner* (March 13, 1933) this Court treated as part of a man's estate certain property over which he had a power of appointment. As Mr. Justice Butler wrote:

> "Here the donor retained until his death power enough to enable him to make a complete revision of all that he had done in respect to the creation of the trust even to the extent of taking the property from the trustees and beneficiaries named and transferred it absolutely or in trust for the benefit of others."

He was very careful to distinguish *Reinecke v. Northern Trust Company,* 278 U. S. 339, where the situation was similar to that in the case at bar and (as to four trusts) the title having been put beyond the control of the settlor, the transfers were held not taxable.

The Government concedes (Brief, p. 11) that a man may escape taxation on income from property by giving it to another without reservation of benefits to himself from the use of the property, and continues "we

submit that Congress may properly say that nothing less than an outright gift will be sufficient to achieve that result."

The settlor in the case at bar did make an outright gift.

In *Marshall* v. *Commissioner,* 57 Fed. (2d) 633, cited by the Government, the gift was held ineffective because "there was not a complete relinquishment of dominion and control of the subject matter of the gift." In our case the relinquishment was complete and absolute. The question of whether a gift is outright and complete must be determined from the viewpoint of the donor, not from that of the donee. If the donor parts with all right, title, interest, power, control and domination of property, he has made a gift (unless he has made a sale). *Basket* v. *Hassell,* 107 U. S. 602. And the gift is none the less absolute and unqualified if the enjoyment by the ultimate beneficiary is postponed. If a man should sell a term for years in certain property and then convey the reversion by way of gift, would the gift be any less outright because the donee could not enjoy possession until the expiration of the term for years?[1] And could Congress constitutionally tax to the grantor the income derived by the holder of the term for years?

In *Burnet* v. *Guggenheim* (February 6, 1933), cited by the Government (p. 12), this Court held that the creation of a trust with power to revoke reserved was not an outright gift but that it did become outright on surrender of the reserve power. Accordingly, the gift became complete although the trust continued, as

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[1] Would the legal effect be different if the intervening term was for the life of the grantor instead of for years?

it does in our case. In our case all power over the properties was surrendered by Mr. Wells before the beginning of 1924.

The fact that the trust is distributable to beneficiaries at the time of the settlor's death does not, as the Government claims, render the disposition in essence testamentary. *Nichols* v. *Coolidge,* 274 U. S. 531, 540. If the settlor had created a trust to accumulate income during the life of A and then to turn the corpus and accumulated income over to B, there would be nothing testamentary in the nature of the gift. The mere fact that his own life and not the life of another measures the period of the accumulation, does not render the gift testamentary.

The Government argues that because the beneficiaries do not come into possession until the death of the settlor, the trust property could be taxed by appropriate statute as a part of Wells' estate. This is directly contrary to *Coolidge* v. *Long,* 282 U. S. 582. If the Government were right, every life insurance policy could be taxed as part of the estate of the insured. This Court, however, has held to the contrary. *Lewellyn* v. *Frick,* 268 U. S. 238.

The mere fact that certain property may be included in a man's taxable estate does not necessarily render the income from that property taxable to him during his life. For example, if property were limited to B for the life of A with a power of appointment in A to be effective upon his death, under the authorities the property over which A has power of appointment would be taxable as a part of his estate, but it is obvious that A could not be taxed during his life on the income received by B.

The present case is even clearer, however, for Mr. Wells had not even a power of appointment over the corpus of the trusts or the insurance policies.[1]

The Government says (Brief, p. 13):

> "* * * the purposes served by the trusts were Wells' purposes. The trustee performed functions prescribed by Wells and achieved results desired by Wells."

If this is to constitute a basis for taxation, then Congress may tax to the donors the income from all endowments which have been given to all our educational and charitable institutions throughout the past.

The Government continues:

> "The trusts existed because of the control which Wells had exercised over the trust property, a control that continued so long as Wells lived, for until his death the trust property here involved could be used only as he had directed."

If Mr. Wells still had any control during the taxable years, he would be properly taxable on the income for those years. But the fact that a man has once had control and has exercised it in an irrevocable manner does not render him taxable for the period of any trust he may have created in disposing of the property. It

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[1] In *Klein* v. *United States*, 283 U. S. 231, and *Tyler* v. *United States*, 281 U. S. 497, cited in the Government's footnote (p. 12) property in which a decedent held a contingent or a vested interest which terminated at the death of the decedent, was held properly taxable as part of the decedent's estate. Mr. Wells has no vested or contingent interest in either the corpus of the trust or the insurance policies.

is true that the *control continues* as long as Wells lives but Wells does not *continue to exercise the control* any more than Mr. Rockefeller continues to exercise control over the moneys he put into the Rockefeller Foundation. As long as Mr. Rockefeller lives and for many years beyond that, his endowment will be "used only as he had directed," but that does not justify Congress in taxing him and his heirs on the income of the Rockefeller Foundation as long as Mr. Rockefeller's purposes continue to be carried out.

Since the settlor had no power to revest in himself any right to any part of corpus or income, and no power of control, appointment or disposition, certainly, as Mr. Justice Butler wrote in *Coolidge* v. *Long*, 282 U. S. 582, 602:

> "The overwhelming weight of authority sustains the conclusion that the succession in the present case was complete when the deed took effect."

The Government cites *Atlantic Coast Line* v. *Daughton*, 262 U. S. 413, for the proposition that there is income in this case which Congress may tax. In that case this Court upheld an income tax to be collected out of the income itself. In our case the Government is trying to collect a tax upon income from a person who does not receive the income and cannot subject it to the tax.

One may receive income indirectly. A might render services to B with the understanding that the compensation for those services would be paid to C, and in that case it would be quite proper to tax the compensation to A as his income. Such was the case in *Old*

Colony Trust Co. v. *Commissioner,* 279 U. S. 716, and the cases of *Adams* v. *Commissioner,* 18 B. T. A. 381, and *Danforth* v. *Commissioner,* 18 B. T. A. 1221. Similarly, if A leases property to B with the understanding that part of the rent therefor will be paid to C, it is proper to tax that part of the rent to A, as in *United States* v. *Boston & Maine Railroad,* 279 U. S. 732, and *United States* v. *Mahoning Coal Railroad Co.,* 51 Fed. (2d) 208. But in all these cases the income which was paid to C was the fruit of the efforts of A or of the property of A, and none of them presents a parallel to the situation in the case at bar, where the income was the fruit of a corpus which was not the property of Mr. Wells but of the Minneapolis Trust Company, as trustee for the benefit of various persons and charities but not for the benefit of Mr. Wells.

Beginning on page 14, the Government's brief stresses an imaginary obligation on the part of Mr. Wells to provide for his dependents, and we can presume that the Government could discover a similar moral obligation to provide for the work of charitable and religious corporations. But it is immaterial whether the obligation is legal or moral or whether there is no obligation. The reason why the income represented by the taxes paid to the United States by the American Woolen Company for Mr. Wood were held to constitute income to Mr. Wood in *Old Colony Trust Company* v. *Commissioner, supra,* was not that those taxes were Mr. Wood's obligation but that they had been paid by way of compensation for his services —he was the earner of the income. The reason why the taxes paid by the Boston & Maine Railroad for the

Fitchburg Railroad were held to be income to the Fitchburg was not because they were an obligation of the Fitchburg but because they were part of the rent which the Boston & Maine was paying for the use of the Fitchburg's property. In the *Mahoning Railroad* case the taxes were paid by the lessee railroad through a mistake of law, but they were paid as part of the rent for the use of the lessor's property and for that reason constituted income to the lessor.

If A, desiring to make a gift to B, compelled by no obligation, legal or moral, renders services to C in consideration of C's paying the value thereof to B, such payment would clearly constitute income to A, *because he earned it.* But if A is indebted to B, and C, as an act of generosity, discharges that debt, the benefit to A is not in the nature of income but in the nature of a gift. The test of whether money paid by C to B for A's benefit constitutes income to A is not whether A is bound to B legally or morally but whether C makes the payment in compensation for services rendered by A or for the use of A's property.

The settlor in providing for his dependents in this manner may have felt relieved *pro tanto* of the obligation, legal or moral, to provide for them after his death, but that does not render the income from the trust his income. As far as he is concerned the situation is no different than if he had made a direct gift to the beneficiaries, with the request that they make investments which they should not disturb during his life and which would provide for them after his death.

In a footnote on page 15 the Government says that if an owner of real property should place securities in

trust for the purpose of using the income to pay his taxes, it is plain that the payment would be income to him. But suppose A placed income in trust to pay the taxes of his daughter—that would be parallel to our situation.

The Government says (p. 15) that:

> "the payment of the premiums from the trust income is a payment for the settlor's benefit as truly as if he had retained the trust property set apart for the sole purpose of paying the premiums, and himself had paid the premiums from the income of the property."

There is this great difference. If the settlor had retained the corpus of the trusts and received the income himself, he could subject a part of it to the payment of the taxes imposed on that income, but since he parted absolutely with all ownership and control over corpus and income, if this tax is assessed against him he cannot pay the tax out of the income that is taxed. And if he should happen to become bankrupt the Government (on its own theory) would be unable to collect any tax, although the income would be received by the trustee and expended for the benefit of the beneficiaries, and in justice and equity should be taxed to the trustee under section 219(b) of the Revenue Acts.[1]

The Government says (p. 16):

> "If Wells' contentions in this case are sustained he has accomplished, by indirect means, that which the law would not permit him to accomplish directly."

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[1] See Appendix, p. 36.

This argument, as well as the Government's argument to the effect that Congress enacted section 219(h) for the avowed purpose of preventing tax evasion, is very conclusively answered in a speech made by Senator David A. Reed while debating the Revenue Act of 1932 (Cong. Rec., v. 75, p. 11765):

> "It is just like a citizen who comes to a river. He finds two bridges, one a free public bridge and the other a toll bridge. He goes over the free bridge. It can not be said that he is evading the toll. He is taking the method which is not taxable, and he is not resorting to the method that is taxable. Nobody can fairly charge him with evading the tax."

cf. United States v. *Isham,* 17 Wall. 496; *Bullen* v. *Wisconsin,* 240 U. S. 625, 630; *Clapp* v. *Heiner,* 51 Fed. (2d) 224, 225.

The Government, to sustain the proposition that Congress may, if it desires, ignore separate entities and tax one's income to another, cites section 240 of the Revenue Act of 1918, which required affiliated corporations to make a consolidated return; but it is noted that the Government cites no authority for the constitutionality of that provision. Soon after its passage, taxpayers realized that the statute was to their advantage rather than to their disadvantage, so no taxpayer attacked it, and of course the Treasury Department does not question the constitutionality of Congressional statutes. The parallel sections of the Revenue Acts of 1924 and 1926 are not compulsory, and taxpayers elect to file consolidated returns only when they think it will be to their advantage.

In the cases cited by the Government on page 18: *Newman, Saunders & Co.* v. *United States,* 36 Fed. (2d) 1009; *Osburn California Corp.* v. *Welch,* 39 Fed. (2d) 41; *Perthur Holding Corp.* v. *Commissioner,* 61 Fed. (2d) 785; *Taft* v. *Bowers,* 278 U. S. 470; and *Cooper* v. *United States,* 280 U. S. 409, the courts upheld the taxation of income to the corporation or individual *who actually received it.* Those cases are in no way comparable to the case at bar.

The Government's paraphrase (pp. 18-19) of the language used by this Court in *Burnet* v. *Leininger,* 285 U. S. 136, 142, is totally unfair, for there is nothing whatever in the *Leininger* case indicating the propriety of taxing a man because his "purposes" were served. A proper paraphrase of the *Leininger* case would show the propriety of taxing trust income against the trust directly or against the beneficiaries of the trust.

The Government (p. 20) claims the same distinction between *Hoeper* v. *Tax Commission,* 284 U. S. 206, and the instant case as between the *Hoeper* case and *Reinecke* v. *Smith,* and quotes some of the language from the latter case. The *Hoeper* case would have been distinguishable from *Reinecke* v. *Smith* whether Mr. Hoeper had ever had title to his wife's property or not. In the *Hoeper* case it was held that the husband could not be taxed on the wife's income and nothing was said to indicate that the rule would be different if the husband had at one time owned the property from which that income was derived. In *Reinecke* v. *Smith* the tax was upheld on the ground of the revocability of the trusts —the power in the settlor to revest the property in himself (the necessity for consent of the trustee being re-

garded as no practical limitation on that power). It was the reserved power of revocation, and not the fact that the settlor had once been the owner of the property, which led this Court to distinguish *Reinecke* v. *Smith* from *Hoeper* v. *Tax Commission.*

(2) *This case is within the doctrine of Nichols* v. *Coolidge,* 274 U. S. 531.

In reply to the Government's second point it may be pointed out that in all the cases of revocable trusts relied on by the Government, if the taxpayer did not like the new tax he could have revoked the trusts and put himself in a position to pay the income taxes out of income from the trust property, but in our case the settlor cannot do that.

In *Nichols* v. *Coolidge,* 274 U. S. 531, 542-3, Mr. Justice McReynolds wrote:

> "And we must conclude that § 402(c) of the statute here under consideration, in so far as it required that there shall be included in the gross estate the value of property transferred by a decedent prior to its passage merely because the conveyance was intended to take effect in possession or enjoyment at or after his death, is arbitrary, capricious and amounts to confiscation."

We suggest the consideration of this language in connection with the following from *Reinecke* v. *Smith*:

> "As pointed out in *Burnet* v. *Guggenheim,* No. 283, October Term 1932, the same considerations as to ownership and control affect the power to impose a tax on the transfer of the corpus and upon the income."

The Circuit Court of Appeals seems to have anticipated this language in writing (R. 66):

> "The relation that must exist between the taxpayer and the income for which he is taxable should be no different than the relation which must exist between a decedent and the property by which a transfer or succession tax is to be measured, and the cases we have cited lead, we think, to the conclusion that the trust property under Trust No. 1 could not have been subjected on petitioner's death either to a Federal transfer tax or a State succession tax. If the trust property may not be made a part of petitioner's estate at death it is difficult to understand how the income therefrom may be part of his income during life."

and accordingly it was justified in saying (R. 65):

> "In Blodgett v. Holden, 275 U. S. 142, it was held that insofar as the Revenue Act of 1924 undertakes to impose a tax on gifts if consummated before its provisions came before Congress it is invalid under the due process clause of the fifth amendment. Even under the doctrine of the dissenting opinion in that case, reading the statute to tax gifts only that were made thereafter, there would be authority for the petitioner's position here as to this trust, which was in the nature of a gift, and was fully consummated prior to the passage of the act."

(3) *Considerations relating to the particular trusts involved in this case.*

Before the Board of Tax Appeals, the Government attempted to avoid the constitutional question only by

contending (1) that Mr. Wells was under obligation to pay the premiums on the insurance policies, and (2) that the provisions in Trusts Nos. 1, 4 and 5, that the trustee was to use the proceeds of certain insurance policies to purchase securities from the petitioner's estate, indicated a beneficial interest in the settlor. The Board of Tax Appeals accepted both of these arguments and to a large extent based its decision upon the former.[1]

In the Circuit Court of Appeals the Government conceded, as it does here, that there was no obligation on the settlor to pay the insurance premiums. And on the first argument before that court it made no attempt to avoid the constitutional question.

When the Circuit Court of Appeals certified the case to this Court the Government revived the argument made in the Board and developed a number of new arguments why the taxes on the income of these particular trusts could be justified without answering the constitutional question. After this Court dismissed the certificate, the Circuit Court of Appeals accorded the Government a rehearing on an enlarged record in order to permit it to present those questions. With the exception of one point, as to accident insurance policies, in which we concede that the Government is right, and which will result in a tax of about $100, the Circuit Court found nothing in any of the Government's arguments that convinced it.

Since the Government has seen fit to repeat those arguments in its brief to this Court it becomes necessary for us to answer them.

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[1] See last paragraph on p. 48 of record.

A.

In Trusts Nos. 1, 4 and 5 it was provided that on the death of Mr. Wells the proceeds of the insurance policies should be used to purchase securities from his estate at their "appraised value." The Government and the Board of Tax Appeals saw in this a right alleged to be of value to the settlor of his estate. The Court may recall that, on the previous argument here, when that point came up the Chief Justice inquired of the Solicitor General how he would appraise that right in determining the value of the estate—a question which was not answered.

The Circuit Court of Appeals answers the Government's contention. After quoting (R. 66) from Section 4 of Trust No. 1, the court says, *inter alia* (R. 67):

> "This provision which we are considering obviously will not enrich petitioner's estate, and is therefore to be distinguished from the situation that would exist had the proceeds of the policy been made payable to the estate. The provision merely anticipates the situation that will exist on petitioner's death, when the trustee will be in need of long-term investments in which to place the proceeds of the policies, and petitioner's estate will possibly be in need of ready cash. The trustee will be a party to the purchase, with a voice in the selection of the securities to be purchased, and as the purchase price is to be the appraised value of the securities there is no possibility by which worthless and unsalable securities will be unloaded from petitioner's estate onto the trustee by virtue of the trust provision. Possibly petitioner had such confidence in his own investments that he was moti-

vated by a desire to have the proceeds of the policy invested soundly and wisely in the interests of the trust estate. At any rate such benefit as will inure by the provision to his estate will be a convenience rather than an enrichment, and will in no way be available to petitioner while living or to his estate in bankruptcy, should he become bankrupt. How is such a future convenience to be measured, either in money or in money's worth, as a present asset of petitioner's? And to be taxable as income, benefits must above all be measurable."

B.

The Government contends that since Mr. Wells might survive all his children his estate might thereby become the beneficiary under Trust No. 4.[1] If this justifies taxing him on the trust income, it justifies taxing any father on all the income of any of his children, because he may inherit from them. The Circuit Court of Appeals answered this argument as follows (R. 80-81):

"As to the first consideration respondent argues that under the Minnesota statute a father may inherit from his children, and thus it follows that petitioner 'may ultimately receive the entire corpus of this trust, both the original corpus and the proceeds of the policies.' Now, obviously, petitioner will never inherit the proceeds payable at death on policies of insurance on his own life. And we have already considered, under Trust No. 1, the possibility that exists regardless of an express provision

[1] A similar contention is made on p. 27 as to Trust No. 5. The answer is the same as herein given with respect to Trust No. 4.

to that effect, viz, that in the event of petitioner's children all predeceasing him the trust estate may revert to him either as grantor, for want of cestui, or as heir of his children. We there held such a possibility not to constitute property in a present taxable sense, citing Coolidge v. Long and Reinecke v. Northern Trust Co., both supra, and not to constitute a present benefit in the sense of income. The same result follows here."[1]

On page 26 the Government describes the assignments of policies Nos. 181485 and 181486 of the Provident Life and Trust Company and claims (p. 27) that "the insured's estate is the beneficiary under these policies, subject perhaps to the right of the trustee to surrender them for cash."

The Government's statements as to the indorsements on the policies are correct but its conclusion is erroneous. Originally, the beneficiary named in the policies was Mary Drew Wells, with the right reserved to the insured to change the beneficiary. (R. 150, 151.) On January 29, 1921, Mr. Wells assigned all his right, title and interest in the policies to Mary Drew Wells. (R. 151.) On May 1, 1923, Mary Drew Wells retransferred everything she had taken under said assignments. (R. 152.) In June, 1923, Mr. Wells, being the owner of the policies, but not the beneficiary named therein (although he had a right to change the beneficiary) assigned the policies to the Minneapolis Trust Company as trustee. These assignments were apparently in anticipation of the dead of trust which was not

[1] The language to which the court referred back appears in the second full paragraph on p. 60 of the record.

executed until August 6, 1923. (R. 122). Possibly in executing these assignments, Mr. Wells overlooked the fact that the named beneficiary was still Mary Drew Wells, and after the deed of trust was executed on August 6, 1923, and accepted by the Minneapolis Trust Company, awakened to the fact that a change of beneficiary from Mary Drew Wells to the estate of the insured should have preceded the assignment; so this deficiency was corrected by the indorsement on August 31, 1923, that the beneficiary was revocably changed, etc. (R. 151.) It is more probable that the request for this indorsement was made at the time the assignments of June 25 were executed but the indorsement had to be made by the Company while the assignments were made by Mr. Wells. It undoubtedly took some weeks to procure the action of the Company in making the indorsement.

In any event, the principle of estoppel by deed is clearly applicable.[1] Mr. Wells assigned all his right, title and interest at a time when his ownership of the policies was imperfect; and his ownership was subsequently perfected. The assignment would operate as to the perfected ownership. The provision in the original policies (R. 150, 156), "that the interest of any

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[1] Particularly as the assignment by its terms transferred subsequently acquired rights. It says (R. 154):

> "I transfer, assign and set over unto the Minneapolis Trust Company, Trustee, * * * all my right, title and interest in the policy * * * together with all rights, privileges and benefits to be derived therefrom and from * * * any other supplementary contract that may be attached thereto * * * with the further full power and authority to receive from the company all sums whatsoever which may become payable under said policy."

beneficiary shall be subject to the right of any assignee of said policy" coupled with the assignments, directly divested Mr. Wells of any interest or ownership in the policies.

The Circuit Court of Appeals' disposition of the Government's contention appears in the central paragraph on page 80 of the record.

The Government's argument as to Provident Life Policy No. 181596 under Trust No. 5 (pp. 27-28) seems to be that Mr. Wells made an assignment which he had no right to make (because he had no property in the policy) but that he later became the owner of the policy through a change of beneficiary which he had no right to make.

If Mr. Wells had any property in the policy, he transferred it to the trustee, as in the case of the policy discussed above (p. 30). If, as the Government suggests (Brief, p. 27) Mary D. Wells was the irrevocable beneficiary, the assignment was ineffective and Mary D. Wells remains today the owner of the policy—Mr. Wells having no interest therein. If Mr. Wells acquired an interest through the death of Mary D. Wells, his interest is vested in the trustee by the assignment on June 25, 1923—equally effective whether made before or after Mr. Wells acquired the interest.

The Circuit Court of Appeals disposed of this point briefly (R. 82), saying:

> "As to all the policies the assignments were complete as regards petitioner. He retained no interest in nor control over them. This statement may be made without specifically pointing out the various

steps in the assignments of the policies and the changes and releases of beneficiaries."

C.

The Government's arguments to the effect that certain of the trusts were void under Minnesota law we considered sufficiently answered in the opinion of the Circuit Court of Appeals. (R. 71-75.)

CONCLUSION

To sum up by quoting excerpts from the opinion of the Circuit Court of Appeals:

> "Can Congress prevent a party from conveying away his property or raise up a fiction by which if he does so he will yet be treated as if he had not? (R. 61.)
>
> "* * * any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law * * *." (R. 62.)
>
> "If the trust property may not be made a part of petitioner's estate at death it is difficult to understand how the income therefrom may be part of his income during life." (R. 66.)
>
> "It is however preferable that there be some tax evasion than that rights guaranteed by the Constitution be lightly set aside." (R. 68.)
>
> "Congress may clearly tax such a transaction as that involved in the instant case for what it really is, a gift inter vivos; but so long as petitioner is willing to relinquish the advantages in order to avoid the burdens of continued ownership and effectively does so Congress may not continue to impose the burdens." (R. 68.)
>
> "We are unable to reach any other conclusion as to Trust No. 1 than that petitioner in creating the trust divorced himself from any beneficial interest in the insurance policy, that he retained no control of any kind over it nor over the corpus of the trust, and that the payment of the insurance premiums by the trustee resulted in no enrichment to him or his estate; that the income sought to be taxed to him was not his income and did not benefit him, that to tax the same to him under section

219(h) is beyond the power of Congress and violative of the Constitution." (R. 68-69.)

The decree of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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APPENDIX

Section 219 of the Revenue Act of 1924 and Section 219 of the Revenue Act of 1926 include the following:

"(a) The tax imposed by Parts I and II of this title shall apply to the income of estates or of any kind of property held in trust, including—

"(1) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust;

"(2) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

"(3) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

"(4) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

"(b) Except as otherwise provided in subdivisions (g) and (h), the tax shall be computed upon the net income of the estate or trust, and shall be paid by the fiduciary. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that * * *

"(g) Where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction with any person not a beneficiary of the trust, the power to revest in himself title to any party of the corpus of the trust, then the income of such part of the trust for such taxable year shall

be included in computing the net income of the grantor.

"(h) Where any part of the income of a trust may, in the discretion of the grantor of the trust, either alone or in conjunction with any person not a beneficiary of the trust, be distributed to the grantor or be held or accumulated for future distribution to him, or where any part of the income of a trust is or may be applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in paragraph (10) of subdivision (a) of section 214), such part of the income of the trust shall be included in computing the net income of the grantor."

Section 1103 of the Revenue Act of 1924 and Section 1213 of the Revenue Act of 1926 provide:

"If any provision of this Act, or the application thereof to any person or circumstances, is held invalid, the remaiander of the Act, and the application of such provision to other persons or circumstances, shall not be affected thereby."